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Budget Accountability in the Department Of Defense

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 December 2005

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ABSTRACT

This analysis of budget accountability in the Department of Defense describes existing budgeting efforts and the application of performance measures for improving both effectiveness and efficiency in budget development and execution. This report first defines performance budgeting and how it applies to the Department of Defense, followed by an overview of initiatives and policies that govern the budget process. An overview of the Navy's actions towards CFO compliancy will also be given to see how effectively it is administering funding. Finally, through this analysis and data collection, this report will provide suggestions to help senior financial managers to accurately assess the effectiveness of their budgets.

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I. INTRODUCTION

A. BUDGETING WITHIN DEPARTMENT OF DEFENSE

1. Introduction

If one was to ask a person from the general public how well the Government's budget is handled, they would get a wide range of responses. What is the foundation for these responses? The answer is the media, news sources and environmental factors. Some people may focus only on the negative aspects of current budget performance. But is all of the Government's budget accountability performance poor? What controls are in place, how does the government budget system work, and who is ultimately in charge? A sample of different perspectives from literary resources and established legislation will be the foundation for understanding the impact of budget accountability today.

The Department of Defense (DOD) has received its fair share of criticism for its performance and financial management of its programs. There has also been difficulty in determining results achieved from the expenditure of millions of dollars of appropriated money. In fact, in 2002, DOD could not account for \$1.1 billion earmarked by Congress just for spare parts.¹ Duplicative efforts and an inefficient use of resources were often the results of new initiatives and programs that were implemented without verification of the existence and effectiveness of similar programs.²

The purpose of this project is to determine what has been mandated by the President of the United States, as well as Congress, for budget accountability within the Department of Defense. The Chief Financial Officers Act of 1990 and follow-on legislation have laid out the foundation for their requirements. DOD has failed to meet CFO compliancy and receive a clean, unqualified audit report to date. Another audit of DOD financial statements will be conducted in 2006, but DOD has significant modifications that must be made for a clean audit to be possible.

¹ General Accounting Office. (2003). *Department of Defense: Status of Financial Management Weaknesses and Progress Toward Reform*, (Report No. 03-931T). Washington, D.C.

² Office of Management and Budget. (2002). *The President's Management Agenda*. Washington, DC: U.S. Government Printing Office.

2. President's Management Agenda

President George W. Bush has established the foundation for performance budgeting in the President's Management Agenda. He gives clear direction for government employees and the military to follow and answers the question of why budget accountability is important. The President has been quoted in the President's Management Agenda as saying, "Government should be results-oriented-guided not by process but guided by performance. There comes a time when every program must be judged either a success or a failure. Where we find success, we should repeat it, share it, and make it the standard. And where we find failure, we must call it by its name. Government action that fails in its purpose must be reformed or ended."³

The President views budget accountability as a long term project, with both short-term and long-term results. He has stated "Good beginnings are not the measure of success. What matters in the end is completion. Performance. Results. Not just making promises, but making good on promises...This Administration is dedicated to ensuring that the resources entrusted to the federal government are well managed and wisely used. We owe that to the American people."⁴

a. The Problem

The most efficient way to make budgetary reform work throughout the government is to properly identify the problem at hand. The President and his staff have listed a variety of significant areas of concern in the Agenda. Specific areas that effect federal budgeting have been highlighted in the section below.

- Improvements in the management human capital, competitive sourcing, improved financial performance, and expanding electronic government will matter little if they are not linked to better results.
- Scarce federal resources should be allocated to programs and managers that deliver results. Yet in practice, this is seldom done because agencies rarely offer convincing accounts of the results their allocations will

³ Office of Management and Budget. (2002). *The President's Management Agenda*. Washington, DC: U.S. Government Printing Office.

⁴ Ibid

purchase. There is little reward, in budgets or in compensation, for running programs efficiently. And once money is allocated to a program, there is no requirement to revisit the question of whether the results obtained are solving problems the American people care about.

- The structure of the federal budget makes it impossible to identify the full cost associated with individual programs. Because the budget does not identify full cost, competition for services has been forced to substitute a separate process governed by complex artificial rules for cost measurement-and this, in turn has acted as a barrier to competition and a source of constant confusion.⁵

b. The Initiative

The next step to tackle these and additional complex problems, while having a lasting impact on budget accountability throughout the government and in the DOD, is to set attainable goals to measure how much change is actually taking place. The plan provided below, addresses some of the key areas that will significantly impact the budget.

- To provide a greater focus on performance, the Administration plans to formally integrate performance review with budget decisions. This integration is designed to begin to produce performance-based budgets starting with the 2003 Budget submission.
- Initially, OMB will work with agencies to select objectives for a few important programs, assess what programs do to achieve these objectives, how much that costs, and how effectiveness could be improved.
- Ultimately, the Administration will attempt to integrate more completely information about costs and programs performance in a single oversight process. This would include budgeting for the full cost of resources where they are used, making budget program and activity lines more parallel with outputs, and, where useful, improving alignment of budget accounts.⁶

c. The Expected Long-term Results

There are many benefits to investing the time and resources required to obtain performance and results that the President is promoting. The President has asked

⁵ Office of Management and Budget. (2002). *The President's Management Agenda*. Washington, DC: U.S. Government Printing Office.

⁶ Ibid

to have better control over financial resources while making program managers accountable for their work. The ultimate goal for the government and DOD is to have a “standard, integrated budgeting, performance, and accounting information systems at the program level that would provide timely feedback for management.”⁷

B. BUDGETARY ACCOUNTABILITY BACKGROUND

The entire nation is affected by these important ideas and initiatives. The scope of the President’s Agenda is huge, but the goal of having a stream lined budget process will benefit future generations while enabling our country to sustain itself as a world power. Movement towards compliance with the Chief Financial Officers Act and the National Defense Authorizations Act is the foundation for meeting the President’s goals.

1. Chief Financial Officers & National Defense Authorization Acts

In fiscal year 2002, DOD reported that its operations involved approximately \$700 billion in assets, \$1.5 trillion in liabilities, 3.3 million military and civilian personnel and disbursements of over \$364 billion.⁸ In 2003, Congress implemented the National Defense Authorization’s Act, which gave greater attention to its business operating systems that compile financial results as required by the 1990 Chief Financial Officers (CFO) Act.

In 1990 Congress passed several laws aimed at improved government accountability. The CFO Act was the first to be enacted. The 1990 CFO Act identified the following: (1) Billions of dollars are lost each year through fraud, waste, mismanagement and abuse among the hundreds of programs in the Federal Government and (2) The Federal Government was in need of fundamental reform in financial management requirements and practices, due in part to use of inefficient and obsolete systems, which were unable to provide consistent, reliable and timely information.⁹

⁷ Office of Management and Budget. (2002). *The President’s Management Agenda*. Washington, DC: U.S. Government Printing Office.

⁸ United States General Accountability Office. (2003). *DOD Business Systems Modernization. Important Progress Made to Develop Business Enterprise Architecture, but Much Work Remains*. (Report No. GAO-03-1018). Washington, D.C.

⁹ United States General Accounting Office. (1991). *The Chief Financial Officers Act: A Mandate for Federal Financial Management Reform*, (GAO/AFMD-12.19.4). Washington, D.C.

Additional laws, such as Government Management Reform Act (GMRA) and Government Performance Results Act (GPRA) were passed to build upon the CFO Act. The Federal Financial Management Improvement Act of 1996 required governmental agencies to implement financial management systems in compliance with federal accounting standards. In addition, the Clinger-Cohen Act of 1996 mandated the use of enterprise architecture as a basis for investing in new systems. Since the inception of the CFO Act and follow-on legislation, DOD has yet to pass a financial audit.

The National Defense Authorization Act for Fiscal Year 2003 was intended to control wasteful spending in DOD on duplicate business systems that have been unable to meet financial reporting requirements. According to a 2003 GAO report, DOD requested \$18 billion to support over 2,300 business operating systems.¹⁰ With the move towards joint operations, the numerous reporting agencies within DOD have been moving away from operating as stand-alone agencies. GAO also reported that DOD's business systems are too complex and prone to errors. Further problems included the lack of standardization across DOD, too many systems performing the same tasks and storing the same data, and the need for manual data entry into these multiple systems.

In September of 2003, GAO conducted a compliance audit. They found that the initial version of the new business architecture does not adequately address federal requirements and accounting standards. The problem of accounting for property, plant and equipment (PPE), still exists and the risk of purchasing duplicate systems remains. In 2004, GAO went as far as to report that DOD's business systems are so fundamentally flawed that they affect mission effectiveness and actually contribute to fraud, waste and abuse.¹¹ As of last year, DOD reported having 2,274 business systems and the Secretary of Defense stated publicly that there may be as many as 5,000 business systems.

¹⁰ United States General Accountability Office. (2003). *DOD Business Systems Modernization. Important Progress Made to Develop Business Enterprise Architecture, but Much Work Remains.* (Report No. GAO-03-1018). Washington, D.C.

¹¹ United States General Accountability Office. (2004). *DOD Business System Modernization: Billions Continue to Be Invested with Inadequate Management Oversight and Accountability.* (Report No. GAO-04-615). Washington, D.C.

In response to DOD's failure to comply with the National Defense Authorization Act of 2003, Congress enacted the Ronald W. Reagan National Defense Authorization Act of Fiscal Year 2005. In accordance with this act, DOD may not obligate funds for business system modernization in any amount greater than \$1 million unless certain requirements are met: The system must be in compliance with the department's business enterprise architecture and it must be necessary to achieve national security.¹²

The importance of proper accounting and financial reporting can not be overlooked by any business or in DOD. While DOD is not a business in the private sector sense, it is necessary to have a singular accounting system for all branches of service. There are a number of reasons why a single accounting system is necessary. Some of the reasons include the elimination of redundant systems, reduction in the amount of money spent on creating extra accounting systems, ease of accessing timely information, and increased financial accuracy, all of which are required to comply with the CFO Act.

C. OBJECTIVES

If one accepts movement towards compliance with the CFO Act and follow-on legislation as the ultimate goal in DOD budgeting, then the compilation of this research should lead to improvements within Department of the Navy. The main objectives of this research are to examine budget accountability within the DOD, to understand the initiatives that have replaced redundant and manual accounting systems and provide a set of useful suggestions to implement within the Navy. Academic literature and research will form the foundation for this analysis.

D. RESEARCH QUESTIONS

The primary research question of this project is: How does DOD approach budget accountability and what is being done to improve the process?

To reach this objective the following supporting issues were explored: (1) The historical and present state of budgeting within the Department of Defense. (2) What has been mandated by legislation for financial accounting and accountability? (3) What are

¹² United States General Accountability Office. (2004), *DOD Business System Modernization. Billions Continue to Be Invested with Inadequate Management Oversight and Accountability*. (Report No. GAO-04-615). Washington, D.C.

the stated goals of the President concerning budgeting? (4) What steps has DOD taken to meet the President's goals? (5) Lastly, what has the Navy done to meet the President's goals?

E. ORGANIZATION OF STUDY

This project is organized in six chapters.

CHAPTER I—Presents a brief description of budget accountability. The President's Management Agenda and Chief Financial Officers Act of 1990 and follow-on legislation are concisely defined. Further it defines our objectives.

CHAPTER II—This chapter lays out the foundation for analysis and presents a literature review to help the reader understand performance budgeting and performance measures. The follow-on legislation mention in chapter I is discussed in greater detail.

CHAPTER III—Lays out the framework for DOD budgeting. A history of the Planning, Programming, Budgeting System and Planning, Programming, Budgeting, and Execution System (PPBE) is given. Within the PPBE discussion emphasis is placed on the importance of execution.

CHAPTER IV—Answers what the Department of the Navy is working on to comply with the CFO Act and the Government Performance Results Act, including Sea Enterprise (the goals that the Chief of Naval Operations has put forth). This chapter highlights the challenges DON faces in being both effective and efficient.

CHAPTER V—Discusses DOD's and DON's objectives for meeting CFO compliancy. Private sector return on investment (ROI) and Knowledge Value Added (KVA) are discussed to show differences in private and public sectors and approaches that should be further researched to help in DOD's transition to a universal accounting system. This transition is being furthered along by Business Management Modernization Program.

CHAPTER VI—Is the concluding chapter. It gives a review of what the authors' objectives were, gives recommendations, and areas for follow-on research based on the findings of this project.

F. METHODOLOGY

This project employed a comprehensive look at Congressional Legislation, government policy and directives, GAO reports, classroom lectures at the Naval Postgraduate School and scholarly literature to understand the current state of budget accountability and the direction DOD is moving. We set out to further determine the direction that the Navy is moving. We looked at what performance budgeting is, requirements for CFO compliancy, and whether DOD is moving towards 'jointness¹³.' The authors' intent with this project was not to highlight faults or cast blame on any particular agency that works on financial accountability, but rather to have an understanding of the workings of it within DOD. It was further not the intent of the authors to state right or wrong, but rather what the current state is.

¹³ For the purpose of this project, 'jointness' will be defined as all branches of the military working together.

II. FOUNDATION FOR ANALYSIS

The purpose of this chapter is to provide the foundation for analysis in subsequent chapters. This chapter accomplishes three major objectives. First it summarizes the literature regarding performance based budgeting. Secondly, the Government Performance and Results Act of 1993 and the Government Management Act are discussed to provide an overview of budget accountability and reform initiatives. Lastly, the chapter ends with a discussion of future change in government and the Department of Defense (DOD).

A. PERFORMANCE-BASED BUDGETING

1. Performance Budgeting

Many reports and studies have cited the need for better results in managing budgetary accounts within the government and DOD. The goal of performance budgets is to link a strategic goal with annual performance targets to verifiable outcomes. John Mercer, an independent management consultant to U.S. and foreign governments on improving governmental performance and accountability and best known for being, “the Father of GPRA,” states; “A performance budget is an integrated annual performance plan and annual budget that shows the relationship between program funding levels and expected results. It indicates a goal or set of goals that should be achieved at a given level of spending. It identifies the relationships between dollars and results, as well as explaining how those relationships are created.”¹⁴ Although this specific definition does not appear to be formally stated on any government website, this precisely defines the intent of the work that agencies perform throughout the DOD. Many DOD websites emphasize the importance of performance measurements, but do not give clear guidance on obtaining the metrics used to judge performance. This suggests that there is some discontinuity between the separate agencies within the DOD and leaves governmental employees with a tough job at hand. Our nation needs to have a budget that exemplifies the qualities of a performance budget. To achieve this goal, reform must take place.

¹⁴ Mercer, J. *Performance Budgeting for Federal Agencies*. Retrieved May 15, 2005, from http://www.john-mercer.com/library/Performance_Budgeting_FA.pdf

Reforming the budget is an ongoing process that cannot continue at its current pace without a set of properly assigned goals and a clear understanding of a desired end state.

Undesirable budget performance and troubling budget accountability have been a source of problems for decades. Rick Mertens, Chief of the Energy Branch for Office of Management and Budget, states that the budget and performance were not integrated from the start. Specifically, he notes three areas that have prevented budget and performance integration: (1) not having costs and results linked, (2) not holding program managers responsible for results, and (3) not having separate systems to compare cost data to performance.¹⁵ Dr. Jerry McCaffery, Professor at the Naval Postgraduate School, further illustrates how complicated accounting systems are by noting that many defense accounting systems have manual entries consisting of 48 characters. The same 48 characters of information must be entered twenty-two additional times into other systems. To make matters worse, this accounting data can not be easily accessed or used to judge performance. This redundant data entry system example shows the reluctance of the government to abandon legacy systems even though we are in an era where computers can simplify work. In an ideal world, the government and DOD would only have one accounting system that could transmit data files easily, while also being a crucial tool to make managerial decisions.

2. Government Performance and Results Act of 1993

In 1993, DOD began promoting a commitment to performance, accountability and results under the Government Performance and Results Act (GPRA). Both the *Department of Defense Implementation of the Government Performance and Results Act* and *The Role of OMB in GPRA Implementation and Performance Budgeting* acknowledge the potential ramifications of the Act. Although seven years separate these two publications, both describe how GPRA fits into the DOD. Alice Maroni, former Principal Deputy Under Secretary of Defense, (Comptroller) at the Office of Management and Budget (OMB), who authored the first study, discusses the benefits of

¹⁵ Mertens, R. (2003, April). *Budget and Performance Integration*. DOE/EPA Annual Information Technology Conference. Retrieved June 10, 2005 from <http://cio.doe.gov/Conferences/AITC/presentations/BudgetPerformanceIntegration2.ppt>

GPRA. Maroni presents a broad framework by beginning with the mission of the DOD, then DOD's vision statement, and then offering a set of six goals to achieve at the DOD corporate level. She gives examples of how GPRA standards are incorporated throughout the Planning, Programming and Budgeting Strategy; (1) DOD components are expected to develop strategic and performance plans that demonstrate linkage to the Quadratic Defense Review (QDR), (2) evaluate the progress of programs, and (3) to ensure performance targets are achievable.

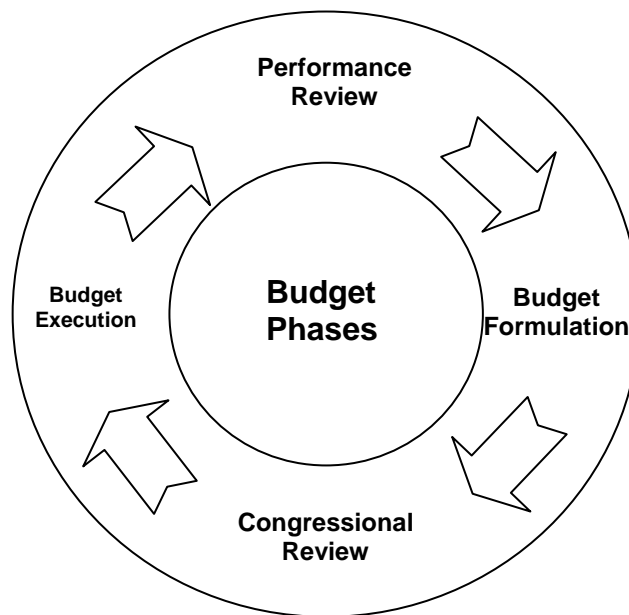


Figure 1. Summary of Budget Execution¹⁶

The article published by the Office of the Secretary of Defense (OSD), *The Role of OMB in GPRA Implementation and Performance Budgeting*, has OMB taking a different approach to using GPRA. OMB works for the President and compiles “agencies’ strategic plans, annual performance plans, and annual reports.”¹⁷ Then OMB takes the compiled GPRA plans to make a unified agency-wide performance plan. One important aspect presented by OMB, but neglected by Maroni, is having agencies use consistent methodologies in budgeting. Consistent methodologies help in setting

¹⁶ Defense Financial Management Training Course. (2005). American Society of Military Comptrollers.

¹⁷ OSD Comptroller iCenter. *The Role of OMB in GPRA Implementation and Performance Budgeting*. Retrieved June 4, 2005 from, <http://www.dod.mil/comptroller/icenter/budget/budgphase.htm>

benchmark standards. These standards can then be used by managers to forecast their budgets by assigning man-hours required to complete a certain task.

a. Reform Challenges

The financial challenges faced by the DOD are addressed by Larry J. Lanzillotta, (former) Principal Deputy Under Secretary of Defense and Deputy Under Secretary of Defense for Management Reform, and Franklin C. Spinney, from Infowar.Com & Interpact, Inc. Spinney offers a nontraditional approach to fixing the Defense budget, while Lanzillotta has a more systematic methodology. Both agree that reliable information is a driving force for positive change.

Spinney's plan is to "teach the Pentagon before it spends." His preliminary strategy is to identify the nation's goals and possible threats. Next, each military service would construct a set of strategies for five different scenarios. The force requirements would then determine the Defense budget. Spinney's plan does have credibility, yet there is already a proven budget process that exists. This process is covered step by step in chapter one of the *Department of Defense Decision Support Systems*. The information of chapter one lays out the responsibilities of DOD's three primary decision making support systems: The Planning, Programming, Budgeting and Execution (PPBE) Process, the Joint Capabilities Integration and Development System, and the Defense Acquisition System. Further explanation of the PPBE process is given in chapter three of this research.

Dismissing Spinney's plan should not be done without careful consideration. He does make some interesting statements throughout his work. He says, "Strategy should link our relations with the external world (goals and threats) to our internal conditions (the constraints of forces and resources)."¹⁸ This suggestion coincides with the Defense PPBE Process¹⁹ and is the basis for PPBE.

¹⁸ Spinney, F. *What Went Wrong? How to Fix It*. Retrieved June 1, 2005 from, <http://www.comw.org/qdr/cspinney.htm>

¹⁹ *Defense Planning, Programming, Budgeting and Execution (PPBE) Process*. Retrieved June 15, 2005 from <http://www.almc.army.mil/hsv/2008-ISE.pdf>

The next issue that Spinney tackles is budgeting in the out years. He emphasizes that “Biased numbers hide the future consequences of current policy decisions, permitting too many programs to get stuffed into the out years.”²⁰ The alarming plan of action that Spinney proposes is cutting the United States' defense spending to match that of our adversaries. Few service members or residents of states dependent upon defense contracts to subsidize their workforce would support such a proposal.

Commander Philip Candreva, lecturer at the Naval Postgraduate School, McCaffery, and other scholars do realize that there is excess capacity in many programs. However, there are less radical ways of dealing with the mismanaged accounts than what Spinney proposes. Lanzillotta, like McCaffery, wants change to come from getting rid of “stove-piped” systems through universally integrated financial programs. Lanzillotta reports that significant improvements in financial reporting include inventorying supplies, cost accounting procedures and accurately reporting the value of plant, property and equipment. All of these successes that Lanzillotta mentions are crucial steps to having budget accountability.

b. Limitations and Inconsistencies

Even with loyal dedication to planning, the defense agencies cannot predict future conflicts with one hundred percent accuracy. The current conflicts in the Middle East exemplify the ever-changing threats that make operational planning and exact budgetary requirements difficult. Spinney suggests that the government needs to spend more time conducting "what if?" scenarios to properly prepare a realistic budget. One step to support Spinney's scenario policy is demonstrated in the governmental publication entitled *Introduction to Defense Acquisition Management* which specifically addresses the four-phase process that takes place to support developing systems and life cycle costs associated with fielded equipment. Shortfalls still exist, even with thousands of man-hours in planning and billions of dollars spent for improvements. Another point of view to consider when budgeting for the military is the supplemental appropriation

²⁰ *Defense Planning, Programming, Budgeting and Execution (PPBE) Process*. Retrieved June 15, 2005 from <http://www.almc.army.mil/hsv/2008-ISE.pdf>.

funds that are supporting the war in Iraq. Some people claim that providing a supplemental in this case is better budgeting because it does not allow these funds to be in the baseline budgets of the military when the war ceases.

Two General Accounting Office (GAO) reports that examine the shortcoming of financial management and reform process, both from 2003, are *Financial Management: DOD's Metrics Program Provides Focus for Improving Performance* and *Department of Defense: Status of Financial Management Weaknesses and Progress toward Reform*. The opening remarks of the GAO's metrics report affirm McCaffery's, Lanzillotta and Spinney's research. Specifically, GAO found that "DOD's archaic and nonintegrated systems either do not contain the transaction-level detail to support the completeness and accuracy of the metrics or they make it extremely onerous and time consuming for the staff to gather and reconcile the needed detail."²¹ The fact that DOD has been unable to reconcile these old financial systems makes more recent budgetary areas cascade out of control. Accounting for travel card expenses and commercial payments are two areas that require reform. The problems from the first GAO report cited here contribute to the financial management weakness described in the second GAO report, which gives a list of inefficiencies and elaborates on most of the topics that revolve around archaic financial systems.

A simple question that has not yet been answered is: How can the government's budgetary system ever change? The answer to this relatively short question is rather difficult. Robert Simons, in his book *Performance Measurement & Control Systems for Implementing Strategy: Text and Cases*, illustrates the difficulties of managing large organizations. Each of the articles reviewed so far has a common theme, which is the need for reform. Since the government is the largest organization in the United States, there are bound to be challenging management problems.

²¹ United States General Accounting Office. (2003). *Financial Management: DoD's Metrics Program Provides Focus for Improving Performance*. (GAO-03-457). Washington, DC.

The Navy's performance metrics²² website gives an overview of six broad areas that the Department of the Navy (DON) is trying to integrate. The highest priority on the Navy's agenda is implementing the President's Management Agenda. To comply with the Agenda the Navy is actively conforming to the GPRA, implementing performance and accountability reporting, and using OMB's program assessment-rating tool.

3. Government Management Reform Act

The Chief Financial Officers Act of 1990 (CFOA) and the Government Management Reform Act (GMRA) of 1994 have been a driving force for the content and format of the Financial Report (FR).²³ The intent of GMRA is to "provide a more effective and responsible government by mandating statutory requirements for reports to Congress, the use of electronic funds transfers for payments, the establishment of a franchise fund in each of the four agencies, and the submission of annual audited financial statements to the Director of the Office of Management and Budget (OMB)."²⁴

The Department of Defense has developed its own goals to achieve the requirements set by the Board for accounting standards. Specifically, "the Department's desires to receive an unqualified audit opinion for all bureau financial statements and consolidated Department financial statements, to strengthen financial controls, and ensure that financial data produced for management decision-making is reliable, verifiable, and consistent with the annual audited financial statements."²⁵

a. Fund Management Challenges

Federal agencies like the DOD are required to prepare "business style" balance sheets on an annual basis as a result of GMRA. In 1998 the GAO concluded that the Department of the Navy's FY96 financial statements "provided data that could be

²² Navy Marine Corps Intranet. (2005, October). *Performance Metrics*, Retrieved June 4, 2005 from http://navweb.secnav.navy.mil/pubbud/gpra/gpra_p_u.html

²³ United States Treasury Department. (2005). *History of the Financial Report of the United States Government*, CFOA/H.R. 5687 (1990, Section 102b). Retrieved August 15, 2005 from http://www.treas.gov/offices/economic-policy/financial_report_hist.pdf

²⁴ OSD Comptroller iCenter. (2005). *Legislation and Reform Initiatives*, Retrieved August 5, 2005 from <http://www.dod.mil/comptroller/icenter/inforef/legislatemain.htm>

²⁵Ibid

used to identify several financial issues that may be of interest to budget and program managers. For example, footnote disclosures on the Navy's accounts receivable and unexpended appropriations raise questions about whether resources may be needed or whether there may be opportunities to reduce resource requirements. To illustrate, if accounts receivable are overstated, the Navy may not receive amounts that it intended to use to support its operations and may therefore need to obtain additional funding, or reduce planned operations. If the amount is understated, the Navy may lack the visibility necessary to ensure that it is taking appropriate action to correct it.”²⁶ DOD actions to transform are crucial for a better equipped force for tomorrow. This example above demonstrates the importance of proper accounting processes and systems but more importantly correct terminology. No matter what the physical forms and entries end up being, the war fighter must be properly supported to the best of our abilities with the money that has been entrusted to program managers.

A secondary example involving a 2003 GMRA audit that examined the effectiveness of accrual procedures for Improving Financial Management at U.S. Agency for International Development (USAID) demonstrates a more recent need for improvement. The audit conducted by the Honorable Everett L. Mosley, Inspector General U.S. Agency for International Development showed that USAID had “material internal control weakness that have not been yet corrected. Specific examples of USAIDs troubling accounting were “\$153 million in un-liquidated obligations that had no payment activity against them for more than one year, indicating that the obligations might no longer be needed for their original purpose.”²⁷ One hundred and fifty three million is small when compared to a DOD budget of over \$400 billion. The point here is a lot of good can be done with \$153 million and that is where new methods and transforming the system come into place.

There is a great deal of improvement to be made throughout the Navy and in a majority of other governmental programs. The examples shown above are specific

²⁶ United States General Accounting Office, (March 16 1998). *CFO Act Financial Audits: Programmatic and Budgetary Implications of Navy Financial Data Deficiencies*. (GAO/AIMD-98-56).

areas for improvement. Some would argue that the benefits are outweighed by the amount of time, effort and resources used to have the DOD comply with business standards. Yet the President and the Honorable Richard Greco, the Assistant Secretary of the Navy (Financial Management and Comptroller), have given clear guidance for further reform. The Navy clearly needs to be “transformed today, to win tomorrow.” Thus it is the responsibility of officials and lead decision makers to make sure that critical information is not lost with the implementation of new reporting systems and that the new standards are incorporated through compatible systems. In short, these and other challenges will be addressed throughout the remaining portions of this research.

B. FINANCIAL MANAGEMENT PERFORMANCE MEASURES

The GAO reports, and findings or conclusions of McCaffery, and Maroni are all examples of works that establish the need for defined performance measures. Spinney took fiscal responsibility to a new level in his article, and it would be difficult to sell this concept to leaders after the shocking events of September 11, 2001. One possibility for tackling this enormous budgetary problem is to examine an individual service. Admiral Vern Clark, the former Chief of Naval Operations, presented his intent for the Navy in an article entitled "Sea Power 21." Admiral Clark envisioned the Navy using best business practices and exploiting technology to reduce the number of ships and people needed while maintaining a strict budget. A third view, by Robert Work, is similar to Admiral Clark's. Work calls for a transformation of the current types of Navy ship platforms. Work outlines his plan in a document called *Winning the Race: A Naval Fleet Platform Architecture for Enduring Maritime Supremacy*. He is a proponent of a 180-ship fleet, which would reduce our current fleet by almost a third. These examples all show the need for applied metrics and an accurate budget accounting system.

The next hurdle is the resistance from existing cultures. Each service and most government agencies have established decades of tradition. Some individuals who work for the government become unwilling to change. Simon, in several of his case studies, discusses the management challenges that exist when people are stuck in old methods. It

²⁷ Mosley, E. L., (September 24, 2003). *Improving Financial Management at USAID* Retrieved from August 5, 2005, from http://www.usaid.gov/oig/whoweare/testimony_092403.pdf

is difficult to eliminate non-players, especially in a governmental system where military personnel rotate jobs quickly but there is a need to meet.

Hedrick Smith, in *The Power Game*, shows that it is not simple to stop government programs. Politics are a powerful thing. Many powerful people at the Pentagon know how to work the system to ensure their programs stay afloat. Numerous examples of mismanaged programs have been revealed throughout the history of DOD, but that is not the point of this research. Leaders need to take the initiative to implement change and use metrics in guiding this reformation.

Joseph Bower, in his case study *Effective Public Management*, says, “The effectiveness of a corporation can be measured by the degree to which it accomplishes its purpose.”²⁸ Gregory Kutz, Director of Financial Management and Assurance for the United States General Accounting Office (GAO), states that, “The excellence of our military forces in Iraq is unparalleled. This same level of excellence is not yet evident in the financial management and other business areas, impeding DOD’s ability to provide complete, reliable and timely information to Congress, DOD managers, and other decision makers.”²⁹ Bower also notes, “Public managers seldom find it possible to make the changes they would like.”³⁰ Managers in large organizations, such as the DOD, cannot give up hope. Heskett’s case study, *NYPD New*, is a good model for changing an entire organization. One very important theme that Heskett discusses is the ability of a manager to get buy-in from his employees when change is occurring. In the military, buy-in often comes through direct orders, but usually does not result in the quality product that management had planned. Simons notes that there must be good communication between management and employees to have an effective business strategy.

²⁸ Bower, J. (1977). *Effective Public Management* (No. 77201). Harvard University.

²⁹ United States General Accounting Office. (2003). *DoD Status of Financial Management Weaknesses and Progress Toward Reform* (GAO-03-931T). Washington, DC.

³⁰ Bower, J. (1977). *Effective Public Management* (No. 77201). Harvard University.

III. DEPARTMENT OF DEFENSE BUDGETING PROCESS

Before identifying performance standards and budget performance measures to solve budget problems, one must understand an overview of the current budget system. This chapter will outline a brief history.

A. OVERVIEW OF PLANNING, PROGRAMMING AND BUDGETING SYSTEM

Over the history of our country, the DOD budget system has become increasingly complex. Yet, as recent as the early 1900s, the budget served primarily to cover the costs of people's salaries, equipment, repair parts and even office supplies. Fifty years later, reforms started to make an impact. During the 1940s and 1950s, performance measures of effectiveness were first developed but these measures did not "ensure that the budget supported the mission or plans of the DOD."³¹

Fortunately, progress increased as time passed. In 1962, Robert McNamara, the Secretary of Defense, created the Planning, Programming, and Budgeting System (PPBS). This system was designed to help the Secretary of Defense in making decisions about resource allocation.³² The overarching goal of PPBS was to "...provide operational commanders with the best mix of forces, equipment and support attainable within fiscal constraints."³³ Strategy was developed based on anticipated threats. Requirements were then determined based on the given strategy, programs were developed, and finally budgetary funding for each program were determined.

³¹ OSD Comptroller iCenter. (2005). *The Historical Context*. Retrieved October 18, 2005 from <http://www.dod.mil/comptroller/center/budget/histcontext.htm>

³² Practical Comptroller Course. *PPBS—How Does it Work?* Naval Postgraduate School, Monterey, CA. Retrieved July 11, 2005, from <http://www.npc.navy.mil/NR/rdonlyres/14F379F8-3330-4FBB-B651-59A6C9F76A74/0/PPBS.doc>

³³ Ibid

The PPBS process was a year-round operation, with each of the three functions (planning, programming and budgeting) conducted on an almost continuous basis.³⁴ The planning phase assessed the threat and defined a strategy to best meet that threat.³⁵ The programming phase converted the strategy into definable programs in terms of force, personnel, material, and money. The budgeting phase articulated the programs in terms of funding requirements.³⁶ The following diagram summarizes the process:

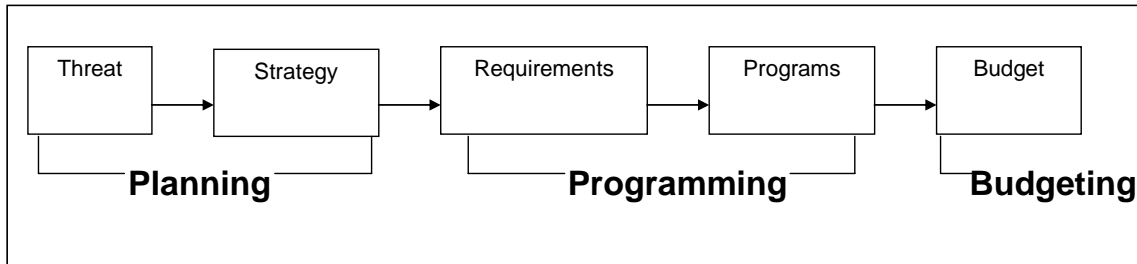


Figure 2. PPBS Process.

PPBS focused more on objectives and purpose, and long-term means for achieving them. Furthermore, PPBS used programming as a means to bring together planning and budgeting. Programming essentially defined a procedure for distributing available resources.³⁷ Prior to the implementation of PPBS, each branch of service worked independently to develop its own budgets. What this meant was that the services worked with few outside influences. Unfortunately, this created a problem because it meant that there was no coordination among the services, which created systems and acquisition redundancies.

PPBS had six governing principles. These principles were:

1. Decisions should be based on explicit criteria of national interest, not on compromises among institutional forces.
2. Needs and costs must be considered simultaneously.

³⁴ Practical Comptroller Course. *PPBS—How Does it Work?* Naval Postgraduate School, Monterey, CA. Retrieved July 11, 2005, from <http://www.npc.navy.mil/NR/ronlyres/14F379F8-3330-4FBB-B651-59A6C9F76A74/0/PPBS.doc>

³⁵ Ibid

³⁶ Ibid

³⁷ Ibid

3. Major decisions should be made by choices among explicit, balanced, feasible alternatives.
4. The Secretary should have an active analytic staff to provide him³⁸ with relevant data and unbiased perspectives.
5. Open and explicit analysis, available to all parties, must form the basis for major decisions.
6. A multiyear force and financial plan is required to project the consequences of present decisions into the future.³⁹

The first phase of PPBS was the planning phase. This phase began with a review of U. S. national security objectives. It also took into consideration the strategies for dealing with the threats to national security. Figure 3 is an overview of the planning phase. The primary output of the planning phase was the Defense Planning Guidance (DPG). The DPG was developed by the Office of the Secretary of Defense (OSD) and the Joint Chiefs of Staff (JCS) based on the inputs they received. The DPG was one of the most significant documents in the PPBS process. It integrated the information from the National Security Strategy of the United States and the National Military Strategy Document. It was the first PPBS document to bring together fiscal and resource constraints.⁴⁰

³⁸ For the purposes of this MBA project, the term “him” or “his” used in this context is, not intended to be gender specific.

³⁹ *DOD's Planning, Programming, and Budgeting System: A Historical Perspective*. Retrieved July 21, 2005, from http://www.mors.org/meetings/cbp/presentations/Gordon_PPBS-Mon.pdf

⁴⁰ Ibid

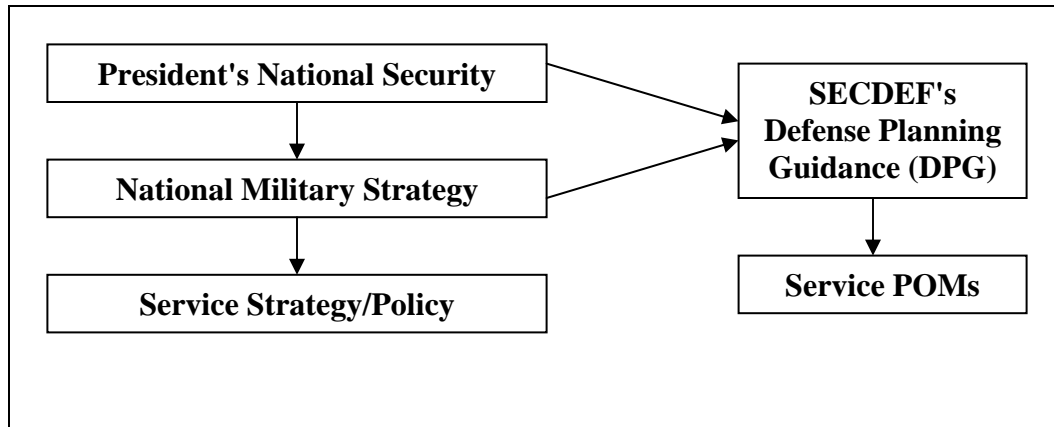


Figure 3. Planning Phase Outputs

The programming phase was the process that translated the information in the DPG into a financial plan for programs. Programming produced a six-year program through a Program Objectives Memorandum (POM) and the Future Years Defense Program (FYDP). The two major steps within this phase were the development and review of the POM.

The final phase of the PPBS process was budgeting. The budget was an expression of the financial requirements to support the approved programs.⁴¹ This phase was complete when the budget was sent to Congress.

B. PLANNING, PROGRAMMING, BUDGETING AND EXECUTION

1. History

The PPBS emphasized objectives and linked planning together with budgeting. For approximately forty years the PPBS was used extensively. As with many programs, there was room for improvement, and so it was with the PPBS. The Senior Executive Council in 2003 was directed to make recommendations for improving the PPBS. Its findings became known as the Planning, Programming, Budgeting and Execution process (PPBE). PPBE is actively used in the DOD today. The new PPBE has many of the same

⁴¹ *DOD's Planning, Programming, and Budgeting System: A Historical Perspective*. Retrieved July 21, 2005, from http://www.mors.org/meetings/cbp/presentations/Gordon_PPBS-Mon.pdf

characteristics as the old PPBS but incorporates a particular emphasis on the execution of the budget, establishes a two-year budget cycle, and includes other modifications of PPBS.⁴²

The PPBE Process enables planners to use forward thinking to meet defense requirements. The main concepts that relate to performance budgeting in the DOD are the planning and execution phases. Civilian and military leaders are struggling to find “the linkages among goals, budget allocation and results.”⁴³ The President and the Secretary of Defense have given direction to take existing budgeting practices and apply metrics to them. The problems that have surfaced when trying to accomplish this Presidential order result when managers do not understand what metrics to apply to their programs.

In September of 2002 the President stated, “The United States will . . . transform America’s national security institutions to meet the challenges and opportunities of the twenty-first century.” By April of 2003, Secretary of Defense Donald Rumsfeld was able to give an update on the changes being made. He said, “The Department currently is pursuing transformational business and planning practices such as adaptive planning, more entrepreneurial, future-oriented capabilities based resource allocation process, accelerated acquisition cycles built on spiral development, output based management, and a reformed analytic support agenda.”⁴⁴

2. Individual Processes

There are four distinct phases in the PPBE process which occur biennially; (1) Planning, (2) Programming, (3) Budgeting and (4) Execution. Each phase will be addressed in sequential order throughout the following sections.

⁴² *Defense Planning, Programming, Budgeting and Execution (PPBE) Process*. Retrieved June 15, 2005 from <http://www.almc.army.mil/hsv/2008-ISE.pdf>.

⁴³ OSD Comptroller iCenter. (n.d.) *Performance Budgeting*. Retrieved June 4, 2005, from <http://www.dod.mil/comptroller/center/budget/perfbudg.htm>

⁴⁴ *The National Security Strategy of the United States of America*. Retrieved September 7, 2005 from <http://www.au.af.mil/au/awc/awcgate/nss/nssallsep2002.htm#transform>

a. Planning

The first phase of the PPBE is the planning phase. “The planning phase identifies the capabilities required to deter and defeat threats. It defines national defense policies, objectives, strategy and guidance for the upcoming programming phase regarding resources and force requirements to meet the capabilities and objectives.”⁴⁵ Planning can be very difficult because of the pressure put on the government to reduce the national deficit while still meeting a vast number of military operational requirements.

A critical area that must be addressed when planning is acknowledging how much risk civilian and military leaders are willing to take. CDR Mark Johnson addressed planning for risk in his presentation entitled the *CNO’s Guidance* given on February 1, 2005 at the Navy Contemporary Guest Lecture series. CDR Johnson’s diagram, shown below, compares combat capability of U.S. military forces to the capabilities of our adversaries. Figure 4 depicts the amount of time that the planning process must allow for industry and defense to produce reliable equipment in order to combat the inevitable threats, which range from network attacks to weapons of mass destruction.

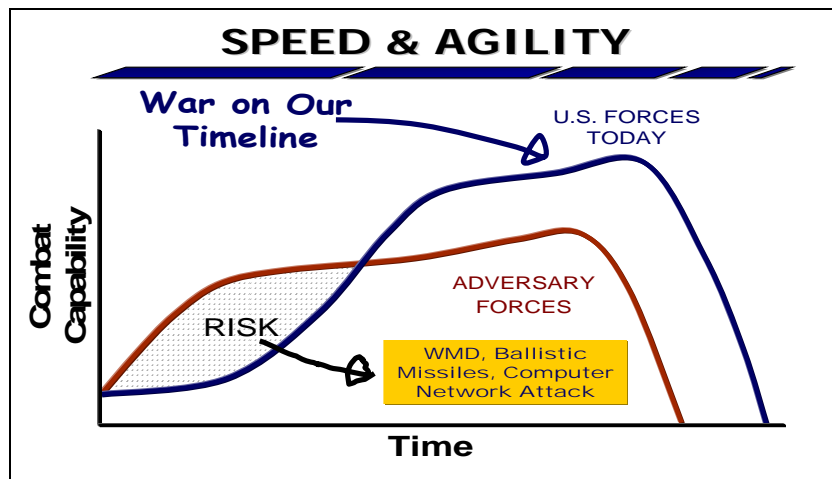


Figure 4. Risk Assessment⁴⁶

⁴⁵ Defense Planning, Programming, Budgeting and Execution (PPBE) Process. Retrieved June 15, 2005 from <http://www.almc.army.mil/hsv/2008-ISE.pdf>.

⁴⁶ Johnson, M. *CNO’s Guidance*. (2005) Naval Postgraduate School, Navy Contemporary Guest Lecture Series.

The main players involved in the planning process are the Joint Staff and the Office of the Secretary of Defense. These decision makers work with Strategic Planning Guidance that provides the initial baseline requirements. The Joint Staff Office and the Secretary of Defense produce the Strategic Planning Guidance. It is a “fiscally constrained guidance that sets priorities and is referred to as the Joint Programming Guidance. The Joint Programming Guidance is then used in developing program proposals by military departments and defense agencies and is known as the Programs Objective Memorandum (POM).”⁴⁷ To reinforce how these components guide and build upon one another, the composition is presented in Figure 5. There is a sequential structure to the planning process, and it provides a checks and balance system to ensure that budgetary and military needs both are met.

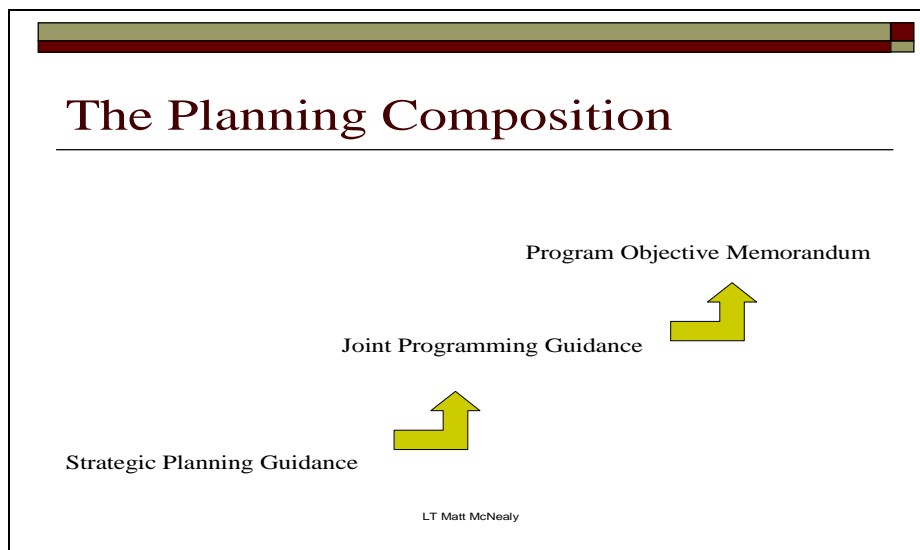


Figure 5. Planning Process

⁴⁷ Department of Defense Decision Support Systems,
http://akss.dau.mil/dag/GuideBook/PDFs/Chapter_1.pdf

b. Programming

Programming can be broken down into two categories: Program development, and program review and decisions. During the program development stage, in even-numbered years, “each Military Department and Defense Agency submits a combined POM and Budget Estimate Submission (BES) to the Secretary of Defense. These submissions cover a six year time frame which takes into account force structure, end strength numbers, and funding for acquisitions of major new systems.”⁴⁸

The program review and decisions occur after the submission of the POM and BES. “The Joint Staff meticulously studies these documents to see how they fit with the Defense Planning Guidance and the National Military Strategy. When the Joint Staff have completed their work, they issue a document called the Chairman’s Program Assessment (CPA).”⁴⁹

c. Budgeting

The budgeting phase occurs simultaneously with the planning phase of the PPBE process. The purpose of the budget is to “convert the programmatic view into the format of the Congressional appropriations structure, along with associated budget documents.”⁵⁰ Accordingly, this budget only accounts for the allocation of resources for the next two years.

The Under Secretary of Defense and the OMB analyze the budgets to ensure that programs are properly funded and to detect any “pork” in the submission. “Pork is a government appropriation that provides funds for local improvements.”⁵¹ This extensive review raises questions that must be answered by program managers. Through

⁴⁸ *Defense Planning, Programming, Budgeting and Execution (PPBE) Process*. Retrieved June 15, 2005 from <http://www.almc.army.mil/hsv/2008-ISE.pdf>.

⁴⁹ Ibid

⁵⁰ *Defense Acquisition Guidebook, Department of Defense Decision Support Systems*, Retrieved May 15, 2005, from http://akss.dau.mil/dag/GuideBook/PDFs/Chapter_1.pdf

⁵¹ McCaffery, Jerry L., & Jones L.R. (2004). Budgeting and Financial Management for National Defense. Connecticut: Information Age Publishing.

a formal process, decisions are made to keep or cut programs. Then, “OMB provides an updated DOD budget as part of the President’s Budget request to Congress.”⁵²

d. Execution

The final portion of the PPBE system, the budget execution phase has received an increased emphasis as a result of Management Initiative Decision (MID) 913, which was signed by the Deputy Secretary of Defense in May 2003. “Fundamental aspects of MID-913 include:

1. Additional emphasis will be placed on program and budget execution
2. A two year cycle that recognizes a four year political cycle
3. Performance metrics will drive (re)allocation of resources in budgets
4. Reviews will be based on outputs (capabilities bought) rather than inputs (what’s the cost).”⁵³

Budget execution consists of the following sequence of events that occur within a set of planned system constraints. The first action is to gain permission to spend appropriations by Congress. Secondly, DOD receives the allotment from OMB and the Treasury. This allotted money is then distributed to each of the separate services and to other additional DOD commands. The services then begin to make budget obligations and spend their allotted money. Comptrollers, program managers and financial managers all monitor the outlay of money as the process continues. A midyear review is also conducted to match funding with the highest priority needs.⁵⁴ Lastly as stated by McCaffery and Jones, “At the end of the year (September), all of DOD must be reconciled with appropriations and spending must be accounted for prior to closing the accounts from further obligation and outlay.”⁵⁵

⁵² Defense Acquisition Guidebook. *Department of Defense Decision Support Systems*, Retrieved May 15, 2005, from http://akss.dau.mil/dag/GuideBook/PDFs/Chapter_1.pdf

⁵³ Candreva, Philip J., (2004) Practical Financial Management (6th ed.). United States Naval Postgraduate School, Monterey, California.

⁵⁴ McCaffery, Jerry L., & Jones L.R. (2004). Budgeting and Financial Management for National Defense. Connecticut: Information Age Publishing.

⁵⁵ Ibid

3. Importance of Execution

As previously stated, execution is the major change from PPBS. McCaffery, Candreva, and GAO point out systems flaws in the budgetary system. The current system has legacy financial systems that do not permit data sharing within the DOD. Millions of dollars in expenditures are unaccounted for because of the lack of information on current assets. The problem only compounds and leads to the government's inability to pass an independent financial audit. McCaffery's article, *The Hidden Process of Budgeting: Execution*, states that although budget execution has received a great deal of attention, "academic literature is still largely focused on budget preparation."⁵⁶

In *The Hidden Process of Budgeting: Execution*, McCaffery highlights the problems associated with budget execution and notes the need for additional research. Legacy systems have been a constant theme repeated throughout each of these studies. Many times when managers look for answers to problems, they only study or become biased by looking at only one perspective. Though each of these analysts has a very different method of fixing the problem, their different perspectives give researchers and decision makers the opportunity to get the best solution with a variety of options.

The GAO reports provide a full account to Congress of the actual standing of the budgetary system. These reports do not hold back the truth and show that there is a great deal of work to be done before DOD can pass a financial audit. The reports do show that there have been great successes in small parts of the agency, but not enough to proclaim that DOD has good budget performance standards.

There are a number of difficulties associated with running a large organization. A GAO report in 2003 called DOD one of the largest and most complex organizations in the world. Pressure from the American public will continue to build for a better return on investment (ROI). ROI will be discussed in detail in chapter five. There is hope of improving the budget system through good leadership and better communication of goals

⁵⁶ McCaffery, J., & Mutty, J. (1999). The Hidden Process of Budgeting: Execution. *Journal of Public Budgeting: Accounting & Financial Management*, 233-257.

to employees. Technology will also be a driving force, allowing better interoperability between computer databases and more timely decision making by managers.

This research shows that there are definite flaws in DOD's methodology. One question is who has overall responsibility for making sure that the DOD has good budget performance? Because the organization is so big, it does not have just one person who can be held accountable for this burden, and this might lead to the problem of timely change. A second area of concern is the lack of successful models to be used as benchmarks to guide each part of the department.

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IV. REFORM WITHIN THE DEPARTMENT OF THE NAVY

Additional research into the area of budget accountability is required for many different reasons. The national deficit gets larger each day in part due to the ‘spend it or lose it culture,’ and not holding managers accountable. A time will come when taxpayers are not willing to give the military additional funding. Smaller budgets would then cause downsizing in the military, involving either weapon systems or manning requirements. A smaller defense program might increase the risk to national security, both in the United States and abroad.

This research on budget performance will contribute to the DOD and the United States as a whole. Specifically, this research should help senior managers effectively monitor their programs and discover areas of excess. It will also teach officers at various levels of responsibility to be as efficient with their allotted funds as possible.

As has been demonstrated here, budget performance is a serious issue. Dedicated practitioners will one day find the proper budget performance measures to help solve the financial problems that have become embedded in the government.

A. DEPARTMENT OF THE NAVY

The world today is filled with new challenges and uncertainties that influence critical decisions of elected officials and military leadership. Significant threats of ongoing concern include the Global War on Terrorism, Homeland Security and Weapons of Mass Destruction (WMD). These threats and concerns can only be taken care of with a well-established plan. The Navy’s initiatives and goals for the future are determined by the Chief of Naval Operations (CNO). This section focuses on the transformation of the United States Navy’s finances by implementing the Sea Enterprise program, which allows funds to be optimized for war fighting capabilities.

1. Sea Enterprise

An overview of where Sea Enterprise fits into the Navy’s plan shows how the Navy's transformation is taking place. “Sea Enterprise will improve organizational

alignment, reduce overhead, streamline processes, and reinvest savings to recapitalize our Navy and deliver increased combat capability.”⁵⁷ This process is presented graphically in Appendix 1.

The question of what Sea Enterprise will deliver is addressed above, but how can Navy personnel and civilians contribute? “We must be innovative in our business process and willing to accept change and build a culture where people feel it is leadership’s role to come to work every day looking for new and better ways to be more efficient and productive.”⁵⁸

Not everyone is willing to just jump on a bandwagon; there will always be resistance. The question of why the Navy is expending so much effort on Sea Enterprise can be answered with three credible responses. First, Sea Enterprise is the “right thing to do for the taxpayer.” Second, the President, Secretary of Defense Rumsfeld and the CNO all know we need to do it. Third, we must do this to keep our Navy capable and effective.⁵⁹

We cannot be caught in ways of the past. The Navy is getting more advanced every day, and everyone needs to use technology to the best of their capabilities. Fortunately, today the CNO Guidance, which is produced annually, is disseminated through multiple publications and pamphlets and is easily accessible over the internet. It is imperative for all career Naval Officers to understand and act upon the CNO’s goals.

Being proactive with the Sea Enterprise program makes sense. The Navy's current dilemma is that its operating and support costs continue to rise. The bottom line is that “we can no longer afford to allow programs to grow at the rate of inflation.”⁶⁰ One solution to the Navy's financial troubles is to focus on initiatives with the best return on investment (ROI) and gather in all its recapitalization dollars.

⁵⁷ Ham, W. T. (2003). CNO Calls On Navy Leaders To Use Resources More Efficiently. *Navy News Stand*. Retrieved August 5, 2005, from http://www.news.navy.mil/search/display.asp?story_id=5416

⁵⁸Kowba, B. *Sea Enterprise*. Retrieved from August 5, 2005, from <http://www.dtic.mil/ndia/2004log/wed/kowba.ppt>

⁵⁹ Ibid

⁶⁰ Ibid

2. The Government Performance Results Act

The Government Performance Results Act has also played an important role in shaping the future of the Navy. The Navy has established performance measures to meet the requirements of GPRA, which are included in the National Defense Strategy, Highlights of the Department of the Navy FY 2006/FY 2007 Budget, Transforming Today to Win Tomorrow and the Department of the Navy Playbook. Each of these sources addresses executing the “best business practices” in the Navy. Specifically, former Chief of Naval Operations, Admiral Vern Clark stresses the importance of best business practices in the Department of the Navy Playbook. To achieve the performance measures set and GPRA requirements, Admiral Clark envisioned the Navy transformation to involve “balancing our naval priorities to deliver the right force, with the right level of readiness, at the right cost.”⁶¹

3. Effectiveness

Admiral Clark expressed his views of effectiveness by saying, “Part of Sea Power 21 is the Sea Enterprise construct. This outfit is learning to operate itself more effectively and more efficiently. Effectiveness is most important, not efficiency. So first, most effective, and when you’re effective, you’re also going to be efficient.”⁶² Effectiveness may be a new concept and new focus for some people. It makes sense when put into practice and can have a dramatic impact when done properly.

4. The Most Bang for the Buck

The challenge to be effective touches all parts of the Navy. Good leaders are ever ready to be as effective as possible. An example of how large organizations in the Navy are doing their part to be more effective comes from Admiral Slaght, Commander, Space and Naval Warfare Systems Command. During his lecture to a group of MBA students at the Naval Postgraduate School, he shared insights into tomorrow’s technology systems. The Admiral said that his counterparts in the Air Force were working on combat equipment similar to that which Navy ships would need. Instead of duplicating the Air

⁶¹ United States Navy. (2004). Playbook 2005. *Navy Strategic Communication Plan*. Retrieved October 18, 2005, from <http://hqinet001.hqmc.usmc.mil/i&L/Pages/LS/LSO/generalInfo/playbook.pdf>

⁶² Ibid

Force's work, he negotiated a contract to have the combat systems made with specific modifications that would allow the equipment to be effective on Navy ships. This saved the Navy millions of dollars that can be used for other programs and personnel requirements.

The Admiral also ensured that present and future products that came out of the Space and Naval Warfare Systems Center (SPAWAR) would be interchangeable and meet the Navy's demanding needs. To take this a step further, the Admiral understood that "Sea Enterprise is more than just saving money; he understood that it is a major revolution in how to support a Navy at sea in this new arena."⁶³

5. The Mechanics

The mechanics of how it all works are the responsibility of the Sea Enterprise Board of Directors, who are transforming the "business" side of the Navy. Key actions already completed include "establishing a Corporate Business Council to facilitate business process transformation, and to foster a culture of productivity and continuous improvement."⁶⁴ The Council has specific functions that include the responsibility to:

1. Develop and advocate high potential, cross-functional initiatives and ensure enhanced performance and organizational efficiencies.
2. Ensure savings are harvested and returned to the leadership for reallocation against other Navy priorities.
3. Track and integrate Echelon II business initiatives, and facilitate barrier removal and organizational impediments to change.
4. Ensure Sea Enterprise and CNO Echelon II Execution Review lessons-learned are leveraged across all commands.

6. Participation

Sometimes great plans are difficult to break down into workable pieces, yet everyone in the Navy has a role to play. The key to Sea Enterprise program success are

⁶³ Nagle, D. NAVSEA Sets 'Sea Enterprise' Revolution in Motion. *Navy News Stand*. Retrieved from August 5, 2005, from http://www.news.navy.mil/search/display.asp?story_id=5570

⁶⁴ Clark, V. (2003). *CNO Guidance 2004*, Retrieved from August 5, 2005, from <http://www.chinfo.navy.mil/navpalib/cno/clark-guidance2004.html>

the people serving in the Navy. The Navy needs to ensure that individuals are most effectively matched to critical billets, and to encourage the growth of individuals' talents throughout the workplace.

Incentives must be established to significantly modify deeply ingrained behaviors and ultimately the culture of budgeting. This could involve activities as varied as cutting down on electrical consumption and not wasting paper. These seem like obvious examples, but every effort counts.

The Navy will always face uncertainties in this ever-changing world. The organization itself may develop some additional goals with newly appointed Chief of Naval Operations, Admiral Mullen. Leaders need to understand that sound financial practices are critical to good program management "to be able to face an unpredictable enemy on an unpredictable battlefield."⁶⁵

A key to the success of Sea Enterprise is that the Navy is not settling for just minor alterations in the legacy systems. It is developing new business practices, making it possible to build the powerful Navy of the 21st century that the United States will rely upon. Through the Sea Enterprise program, the United States we will obtain the Right Force, with the Right Readiness, at the Right Cost.

⁶⁵ Nagle, D. NAVSEA Sets 'Sea Enterprise' Revolution in Motion. *Navy News Stand*. Retrieved from August 5, 2005, from http://www.news.navy.mil/search/display.asp?story_id=5570

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V. ACCOUNTING SYSTEMS, INCENTIVES, & PERFORMANCE MEASURES

A. DEPARTMENT OF DEFENSE OBJECTIVES

One significant question that must be answered is how should the Department of Defense quantify its investment decisions? There has been a recent push for all government agencies to be able to pass a financial audit.⁶⁶ The theoretical dilemma this presents is that DOD and civilian businesses do not share the same practices. For instance, civilian companies use some form of depreciation to account for their property, plant and equipment. However, how would the Navy depreciate a guided missile destroyer or a naval station? It would seem that this should be as simple as dividing what they paid for the system by its useful life. Some capital assets and buildings are indeed depreciated, yet, the accounting systems for this simply are not available for all assets that DOD has so it is presently not achievable at an acceptable cost to DOD. This change would require both an accounting practice change as well as a change in culture within DOD. This is only one of the reasons why DOD has not been able to achieve a clean audit. Another reason may be that the DOD is not in the business of making money, but rather providing defense. This is not to say, however, that DOD is not in the business of maintaining accurate financial records; providing efficiently for defense means having reliable and effective financial management (FM) and accounting systems.

In order to quantify and evaluate investment decisions, DOD must analyze today's threats to national security given fiscal limitations. To facilitate this, there has been a push to compute return on investment (ROI). ROI analysis gives leaders another tool to help determine how to invest money. This calculation can be particularly useful when comparing options. While this is common practice in the private sector, this concept is very difficult to apply in DOD.

⁶⁶The United States General Accounting Office. (1991). *The Chief Financial Officers (CFO) Act of 1990 (Public Law 101-576) & The Chief Financial Officers Act: A Mandate for Federal Financial Management Reform*. (GAO/AFMD-12.19.4).

B. PRIVATE SECTOR ROI

ROI formulas have been utilized by private sector businesses for a number of years. In its simplest form, ROI can be calculated by dividing Net Income by Amount Invested. The Du Pont method is a commonly used model and expressed by the following flow chart:

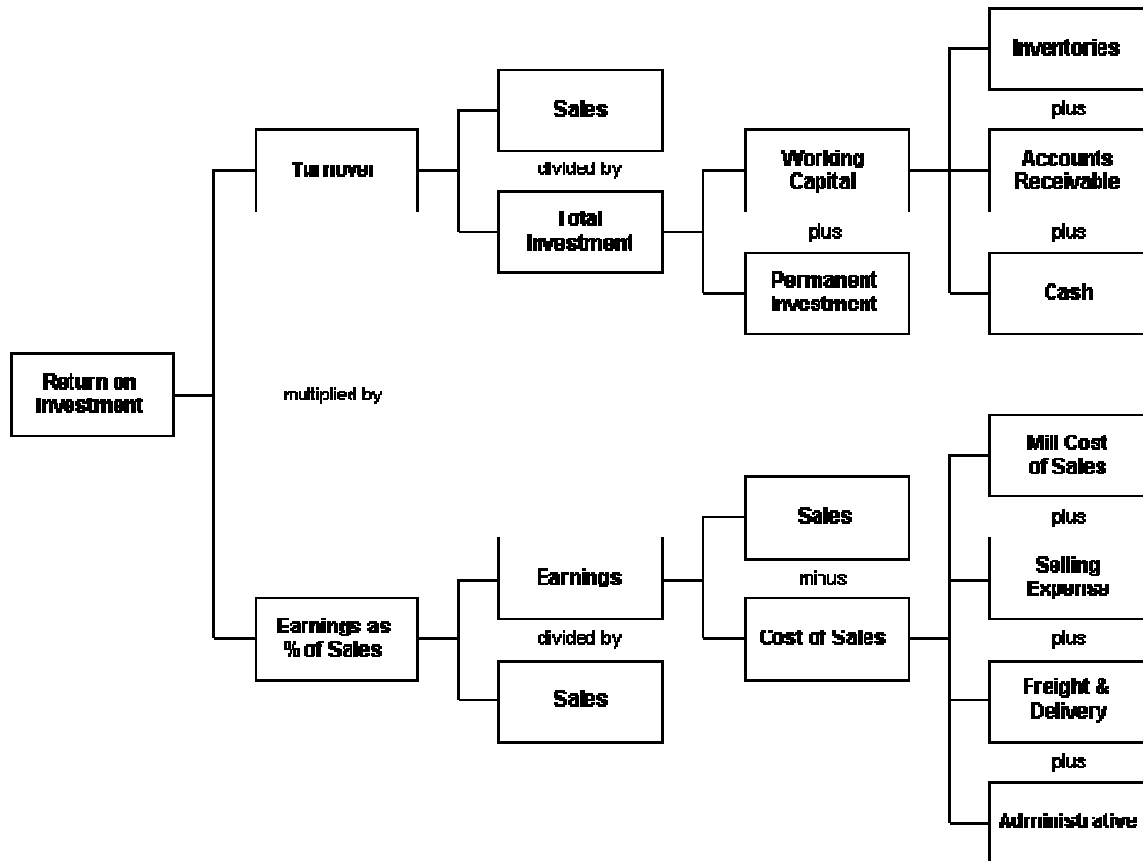


Figure 6. ROI⁶⁷

Several factors influence this calculation, including time and scope. In order to account for time, the funds must be discounted to reflect the Net Present Value (NPV). Just because ROI may return a positive result, it may not be optimal.

⁶⁷ Johnson, H. T. & Kaplan, R. S. (1991) *Relevance Lost: The Rise and Fall of Management Accounting*. Harvard Business School Press: Boston. Retrieved from <http://home.att.net/~nickols/dupont.htm> on 31 August, 2005.

1. Applying Public Sector ROI to DOD

As previously mentioned, the equation for ROI is net income divided by investment. The denominator in the equation (investment) is reasonably well defined for the private sector. However, it can be difficult for the public sector to make such a determination because it is challenging to capture all investment costs in some projects due to the legacy accounting systems used by the government. Within DOD, contributions to a particular program may come from another program's fund or an appropriation whose tracked information may not be shared.

The numerator, net income, is even more difficult for DOD to calculate. As was mentioned above, DOD is not in the business of making money, so net income does not have a translation into the private sector. Net benefit is usually used vice net income for this reason. Calculating net benefit requires making assumptions. The question could be asked, "What is the benefit of national defense, or combat effectiveness?" How does one calculate the value of such intangibles? Admiral Vern Clark captured this sentiment in the following remarks,

You know, in the business world they would call this organization one of the good returns on investment companies. This is about a relatively small investment in national security for the United States of America. It is about a huge return, a huge return on investment. It's too bad you couldn't list this company on the stock market the way things are going. It would help the Dow, wouldn't it?... (It) is all about being the exemplar of readiness and combat effectiveness. It's about outstanding performance in this war on terrorism...⁶⁸

The significance of this remark is that many would say that quite a lot has been invested in the military, with no defined way to measure the return.

C. CURRENT DOD EFFORTS

There are few examples where ROI has been clearly tied to program decisions. One such example is

⁶⁸ Clark, V. Remarks at Change of Command, Naval Special Warfare Command, San Diego, CA., August 8, 2002. Story Number: cno021118-28. (November 18, 2002) Retrieved August 31, 2005 from http://www.news.navy.mil/search/displaybbs.asp?bbs_id=358&cat=2

A truly joint force can be achieved with greater efficiency and less friction if the Services' requirements, acquisition, and resourcing functions, including control of funding appropriations, are administered or adjudicated by a single commander, Joint Force Commander (JFCOM). The concept of a single unified commander conducting these functions is not unprecedented. The U.S. Special Operations Command (SOCOM) uses this type of system, allowing special operations forces (SOF) **to maximize the return on their investment**... The entire process, providing solutions to requirements across all service components of SOF, is under the control of a single commander.⁶⁹

D. CURRENT NAVY EFFORTS

In the 2005 CNO Guidance, Admiral Clark used return on investment to discuss recruiting considerations:⁷⁰

- Ensure *savings are harvested and returned* to the leadership for reallocation against other Navy priorities.
- We established the Assistant CNO for Information Technology (ACNO-IT) to promote Navy-wide alignment between warfighting and business information technologies, and to ensure IT investments and resources are targeted for highest value efforts and *return on investment*.
- Conduct an Expeditionary Strike Group Sea Swap experiment in FY05. While awaiting live testing, conduct computer modeling simulation to provide initial assessments of feasibility and *return on investment*. (CFFC by Jun 05)
- Review ship (preventative/routine/intermediate/depot) maintenance practices and *quantify corresponding return on investment*. Report on innovative ways to support FRP readiness while preserving safe and effective operations. (CFFC lead, NAVSEA, TYCOMs, by May 05)
- [Develop] an analytical process for warfighting “wholeness” and a methodology by which modernization plans can be evaluated for *return on investment* (e.g., platform life cycle cost), overall value to warfighting and risk. (OPNAV N6/N7)
- Facilitate business process transformation and foster a culture of productivity and continuous improvement enterprise-wide. Develop and advocate high potential, cross-functional enterprise initiatives and ensure

⁶⁹ LCDR Cruden, Michael S., MAJ Keith A. Hattes, USA, Maj Mark A. Suriano, USAF, *Unity of Command for Joint Acquisition: A Key to Transformation*. Joint Forces Staff College, Joint and Combined Warfighting School – Intermediate, Class 04-1, 5 March 2004.

⁷⁰ Clark, V. 2005 CNO Guidance, January 3, 2005. Retrieved August 22, 2005, from http://www.globalsecurity.org/military/library/policy/navy/cno-guidance_2005.htm

enhanced performance and organizational efficiencies are not lost in the “white space.” *Ensure savings are harvested and returned* to the corporation for reallocation against other corporate Navy priorities.

The Navy has focused on finding a solution to the ROI problem, in response to the CNO’s guidance, but there have been few results.

E. KNOWLEDGE VALUE ADDED

Knowledge value is something that is often overlooked. In many ways, knowledge could be one of the most valuable assets of DOD. Knowledge in this sense is often referred to as intellectual capital. Research in the field of knowledge management has already been performed by the United States Air Force and many private sector businesses. Generally speaking, knowledge management is the practice of promoting the generation of new knowledge, the codification of knowledge and the ability to transfer that knowledge. Knowledge management is done to garner the benefits of intellectual capital.

Knowledge generated could be considered revenue generated. If this generated knowledge, or revenue, along with the associated costs could be captured, then a comparison could be done to help calculate ROI. This metric is known as Knowledge Value Added (KVA). KVA is based on the premise that all knowledge within an organization contributes to its outputs.⁷¹ The KVA metric puts knowledge into a numerical value. Dr. Thomas Housel, professor at the Naval Postgraduate School, suggests that value can be assigned to knowledge based on learning time. The total amount of training required to adequately be able to perform a function is its learning time. Another way to look at this would be the total amount of time required to train a similarly educated person to replace someone already in the position. For example, if it takes 200 hours of classroom and drill field time to train a basic recruit, plus four week of on the job training (OJT), then the knowledge generated by the recruit is 360 hours (200

⁷¹ Housel, T. & Bell, H. (2001). *Measuring and Managing Knowledge*. McGraw-Hill/Irwin, Singapore. Retrieved August 19, 2005 from <http://www.students.yorku.ca/~martyv/venalainenWRIT.pdf>

hours plus an average of 8 hours per day spent on OJT for four weeks, or 160 hours). For the above example, Knowledge Value Added can be used to generate Return on Knowledge (ROK):

$$\frac{\text{Number of Recruits} * \text{Learning Time}}{\frac{\text{Number of Recruits} * \text{Work Time} * \text{Cost}}{\text{Work Time}}} = \text{ROK}$$

Calculating multiple ROK's for different sections of recruiting might tell the military where to better spend money to improve the return of an organization. Program Managers may be able to benefit from this methodology as well. In determining which projects provided the greatest value to the overall program, KVA provides a means to compare the outputs of dissimilar projects.

F. POINTS OF INTEREST IN THE CFO ACT

Choosing the direction to take that will drive federal agencies to the desired reforms has proven to be very difficult. There are two specific points in the CFO Act that will be discussed in this section: 1) The requirement to prepare financial reports in the accrual system while still operating under the obligation basis; and, 2) The requirement for federal agencies to prepare private sector business style balance sheets.

Money is appropriated annually under an obligation basis by Congress. The closest private sector system to this is a cash accounting system. Cash accounting requires expenses to be recorded when payment is obligated or when revenue is actually received. In contrast to the cash system is the accrual accounting system. Under the accrual system, income and expenses are recorded when a sale or purchase is made, regardless of the actual exchange of funds. A business can use the accrual system to give a sound indication of the business's financial health. Still another method commonly used by state and local governments is a modified accrual system. This type of accounting requires revenues to be recorded when they become available and

measurable.⁷² Interestingly, of the three accounting methods above, modified accrual, which is the most conservative, is the only system that the CFO Act does not require.

The requirement for business style balance sheets is a daunting task for DOD because the requirement for them is new. Progress has been made towards this aim and having a singular accounting system will allow DOD to have more accurate financial statements. All of this, in turn, will lead to better accountability, better understanding of what resources are attributed to, and will allow the public to hold DOD responsible for its actions.

G. BUSINESS MANAGEMENT MODERNIZATION PROGRAM (BMMP)

Secretary of Defense Donald Rumsfeld gave a speech at the National Defense University titled “21st Century Transformation.” In this speech he discussed events in November of 2001. He stated, “That day, on the plains of Afghanistan, the 19th Century met the 21st century and defeated a dangerous and determined adversary—a remarkable achievement...this is precisely what transformation is about...It shows a revolution in military affairs is about more than building high tech weapons. It is also about new ways of thinking and new ways of fighting.”⁷³ Change is a requirement of today’s Financial Management and accounting systems. As discussed previously, billions are spent each year to design, build and maintain multiple business operating systems. In order to provide better service to the warfighter, the Business Management Modernization Program (BMMP) was developed.

Before BMMP there was a stovepipe approach to financial reporting. Disparate and un-relatable FM and accounting systems lead to non-integrated, non-interoperable and cost ineffective capabilities, which made for inaccurate, unreliable and untimely financial information.⁷⁴ This brought about change mandated by the Secretary of

⁷² Fiscal Crisis and Management Assistance Team. (2004) Do You Have a Good Definition of Modified Accrual Accounting. Retrieved August 19, 2005 from [http://www.fcmat.org/stories/storyReader\\$1147](http://www.fcmat.org/stories/storyReader$1147)

⁷³ BMMP. Business Transformation. (2005) Retrieved August 19, 2005, from <http://www.dod.mil/bmmp/index.html>.

⁷⁴ Santana, C. (2003) *Department of Defense Financial Management Modernization Program*. Retrieved September 30, 2005, from <http://www.dtic.mil/ndia/2003interop/Santana.pdf>

Defense. He stated, “One of my highest priorities is to have reliable, accurate, and timely financial management information upon which to make the most effective business decisions...we must change the Department’s business operations and systems...Toward this end, I hereby establish a Department –wide Financial Management Modernization Program (FMMP).”⁷⁵ Secretary Rumsfeld the following year to say that each branch of service must adopt the perspective that the time to change the way we operate is now.⁷⁶ He further stated that the global war on terrorism does not supplant the need for transformation, but rather DOD must accelerate its business, operational, and process reforms.⁷⁷

It was determined that business needs must drive the architecture. To this extent, the goals of FMMP were:

- Accurate, reliable and timely information
- Informed, effective business decisions
- Increased operational efficiency and effectiveness
- Visibility to cost incurred
- A clean audit opinion⁷⁸

The intent of FMMP was to get better information for decision making, reduced cost of business operations, supported by a skilled workforce and has fewer, more capable, integrated systems. The enterprise architecture for DOD’s future business environment was to have defense-wide standards and new business practices.

From FMMP was born the Business Management Modernization Program. The mission of the BMMP is to, “Transform business operations to achieve improved warfighter support while enabling financial accountability across the Department of

⁷⁵ Memorandum dated 19 JUL 2001 from SECDEF on *Financial Management Information within DOD*.

⁷⁶ Memorandum date 17 SEP 2002 *Legislative Priorities for Fiscal Year 2004*.

⁷⁷ Ibid.

⁷⁸ Department of Defense Financial Management Modernization Program slide presentation 03 April 2003. <http://www.dtic.mil/ndia/2003interop/Santana.pdf>. Information Retrieved 30 September 2005.

Defense.”⁷⁹ BMMP is a tremendous undertaking and will take a number of years to complete, but is a giant step in the right direction to correct current flaws in DODs systems. BMMP has three main objectives:

1. To define the future business capabilities necessary to support the warfighting Mission, and focus the activity of business system modernization on acquiring those business capabilities.
2. To define and declare business capabilities that should be common throughout the DOD business enterprise and direct the implementation of enterprise-wide systems with greater visibility at the highest levels of leadership within the Department.
3. To control current and future investments in business systems, through the governance of the Defense Business Systems Management Committee (DBSMC) and Investment Review Boards (IRBs).

It is clear that what must happen is the transformation of DODs business operations to achieve improved warfighter support while enabling financial accountability.⁸⁰

Defense business transformation is being refocused. The goal is to design, guide, and rapidly employ a priority suite of information-driven capabilities that reflect DOD Core Business Missions (CBMs). The CBM structure serves several purposes: It provides a framework for a system that supports warfighting missions, it is useful to explain how major modernization programs impact business missions and it serves as a base structure for organizational alignment of the BMMP.⁸¹ This is shown in the diagram below.

⁷⁹ BMMP. Business Transformation. (2005) Retrieved August 19, 2005, from <http://www.dod.mil/bmmp/index.html>.

⁸⁰ Ibid

⁸¹ Ibid

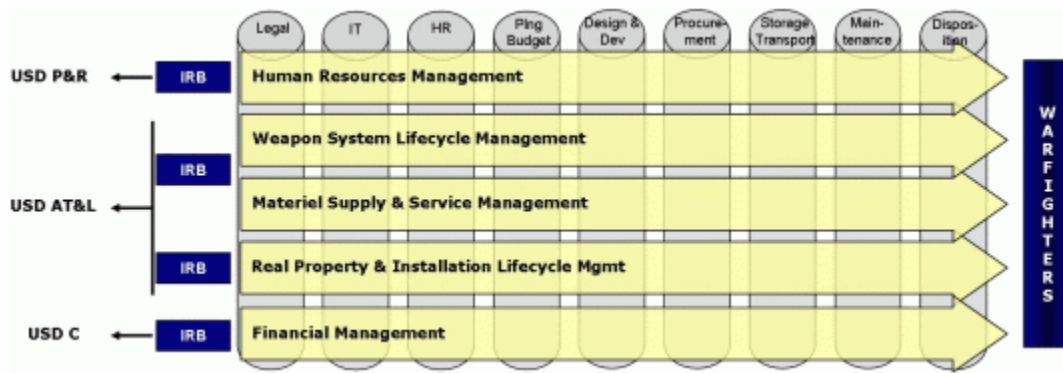


Figure X

While each CBM has its own distinct function, it is interdependent in supporting today's military.

VI. SUMMARY

Chapter II laid the foundation for analysis of budget accountability in the Department of Defense and discusses legislations that mandate accounting standards. Chapter III described a brief history of the budgeting process. Chapter IV explains reform initiatives that are taking place within the Navy and the actions of the Navy to comply with legislations. Chapter V addresses the movement towards CFO compliancy in the DOD and throughout the Navy. This chapter discusses the purpose for this study and comprehensive review of the underlining goal. Finally, this chapter concludes with suggestions for further research.

A. REVIEW OF THE GOAL

The CNO's guidance for 2006 is a map for meeting the challenges of a new era. It is a long-term vision for the Navy. His priorities include sustained readiness for the war on terror and any other armed conflicts that may arise in the future. He states that the Navy will build a fleet for the future with the right size and mix of capabilities balanced against the right price for tomorrow. He also emphasizes that building the 21st century leadership will be done through transforming manpower, personnel, training and education organization. Some of his specific goals include:

- 1) Win the war on terror and stay ready to meet other operational requirements;
- 2) Determine and deliver on the navy s future force structure requirements;
- 3) Drive to execution sea warrior and other ongoing manpower and personnel Transformational efforts;
- 4) With the United States Marine Corps,
Increase the value of naval contributions to the joint force;
- 5) Develop closer working relationships with the United States Coast Guard and other governmental and non-governmental organizations;
- 6) Apply effects-based thinking across the navy; and
- 7) Become leaders of change and innovation.

He makes it clear that the Nation and the Navy are at war and living in an era plagued with uncertainty. He wrote, “It is an era that calls for new skill sets, deeper partnerships, mutual understanding and –with the great majority of international commerce still moving on the world’s oceans—a firm commitment to the incredible power resident in the sea itself. We will answer the call.”⁸²

Admiral Mullen gives further guidance that harnessing sea power demands better joint and interagency cooperation and a future fleet of ships, aircraft, and submarines to wield this power across the spectrum of conflict. Finally he states that the Navy-Marine Corps team is not just an instrument of war, but also of peace.⁸³ “...we cannot meet the challenge of this new era simply by sustaining today’s readiness and requirements. Our adversaries will not rest; our friends and allies cannot wait. Building upon Sea Power 21, we must continue to transform, **recapitalize**⁸⁴ and modernize our Navy.”⁸⁵ The authors’ have highlighted these sections of the CNO’s guidance to show that the DON is indeed in a period of transition. DON can no longer afford to remain fixated with legacy systems, but must embrace the requirements set forth in the CFO Act and follow-on legislation. The CFO Act may not be the panacea of solutions, however, moving towards CFO compliancy moves DOD towards the desired end state of budget accountability.

B. CONCLUSIONS

The reality of the situation is that to make changes in the way DOD does business concerning financial accounting is not a simple process. It will take time, commitment to change and a shift in culture to make it a possibility. In chapter I of this project, the authors’ stated that CFO compliancy would be a difficult task. According to a Government Accountability Office report from October 2005, the Office of Management and Budget should request congressional review on the performance issues and program areas most in need of review. GAO also suggests that Congress consider a structured

⁸² Mullen, M. (2005) *The Chief of Naval Operations Guidance for 2006*. Information retrieved October 27, 2005 from <http://www.npc.navy.mil/NR/rdonlyres/90E6BAD1-8E46-4748-973E-52204E441DFF/0/NAV05272.txt>

⁸³ Ibid

⁸⁴ Bold added for emphasis by authors

⁸⁵ Ibid

approach to articulating its priorities for key programs and performance goals. DOD must work with Congress to see these changes through. Steps have been taken to clarify this relationship, but many agencies will continue to struggle to balance the differing needs of the budget and planning processes and their stakeholders.⁸⁶

- Chapter I stated that this CFO compliancy would be a difficult task. GAO from OCT 2005 tells where we are and why this is so difficult.
- Largest business organization in the world.
- DOD and Congress must change as outlined in GAO report 06-28.

C. RECOMMENDATIONS FOR FURTHER RESEARCH

We suggest further research in the following areas:

- Feasibility of a singular accounting system.
- Definition of Effects Based Thinking and how it will play a critical role in transition.
- A more thoughtful analysis could be conducted to assess the existing performance metrics. Recommendations of more relevant and executable performance measure could be provided to improve the information used for resource allocation decisions.
- Research into any of these areas would be extremely valuable contributions to the Navy's attainment of Budget Accountability and in accordance with the 2006 CNO's Guidance.

⁸⁶ Government Accountability Office. (2005). *Performance Budgeting: PART Focuses Attention on Program Performance, but More Can Be Done to Engage Congress*, (Report No. 06-28).

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